INTERVIEW

Deceptively Simple Credit Spreads

Income-Generating Strategies With Brad Reinard

Brad Reinard, who is editor-in-chief of Monthly Cash Thru Options LLC, has extensive experience in directional and nondirectional option trading strategies. He has consistently returned greater than 40% annually in his own personal trading account since 2002, primarily leveraging out-of-the-money credit spread and iron condor options on the broad indexes. He has a bachelor's of science in electrical engineering from Columbia University and a master's in business administration from the University of Chicago Booth School of Business.

STOCKS & COMMODITIES Editor Jayanthi Gopalakrishnan and Staff Writer Bruce R. Faber spoke with Reinard on December 11, 2012.

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Brad, why don't you start by telling us about yourself and how you got interested in trading options.

I am an electrical engineer by trade. I worked in the General Electric Spacecraft Group in New Jersey for three years and then got an MBA from the University of Chicago. From there I moved out to Silicon Valley, and I stayed in high-tech. My expertise was in chip design software. I was selling to all the semiconductor companies like Intel, AMD, and Fujitsu.

All that time, I was trading stocks. Even with the day job, I was constantly trading stocks, especially the high-tech ones. I was in and out of stocks and did pretty well, but I kept hearing about options, so in 1998 I took a training course. I just started from there.

My recommendation to people who ask me, "I want to get started [trading options]. What do I do?" I tell them to take a two-day class, because they'll come home with books and materials, DVDs and CDs. Put time into it and start learning. Once they find a strategy they like and gravitate toward it, sign up for a newsletter and follow someone who has five or more years of experience in that strategy and learn from them; they have already gotten kicked in the teeth over and over. They already lost money as they learned the strategy. So there is no reason to lose money if you can just follow someone who has already been through it. After about a year you will get pretty good at that strategy.

I did all that, and I gravitated toward selling versus buying options. I really like the selling side. I like bringing in premiums using credit spreads and iron condors. I followed a couple of newsletters for about a year and a half, and after a couple of years I realized I could do a better job than what these folks were doing. So I launched MonthlyCashThruOptions.com [MCTO] in 2004.

Then I started getting customers in 2005. Now we have customers in all 50 states and 35 countries. We let customers self-manage because we have a newsletter that we send out every Sunday, plus we autotrade for about 75% of our customers. We do that through a few different brokers: OptionsXpress, TD Ameritrade, TradeMonster, Global AutoTrading, and others. I went full-time in this about four years ago and just started focusing on the newsletter. I am now building out a trading firm.

We have a couple of traders on board and are in the process of bringing on a third, and we are building new funds. We are going to launch them as retail products that can be autotraded. They will have low correlation to our current strategy, which are the credit spreads and iron condors. This allows our customers to diversify because they are constantly asking us, "What else do you have? You are telling me not to put more than 35% of my money into any particular strategy, so I have 35% dedicated to MCTO. What else do you have for me?"

Up until the last six months I had nothing for them. We still have not launched the funds yet, but we are getting there. We are still working on them, still building track records, and we should start launching our next fund in the next three to four months.

You look at lot of indicators and variables. Why is it so important to look at all this data?

If you are purely a technical trader, you can get hurt badly once every year or so. When most people get started they are technical in nature and they follow the charts, moving averages, candlesticks, maybe volume, but a lot of people don't jump into the volume until they start getting more experienced. So they look at price-based indicators and price-based charts, which is fine. It works if you are a directional trader opening trades with shorter duration, usually two weeks or less. It works with more of the trend-following trades. But it is much better to do technicals *plus* making your best guesstimate and prediction of where the market is going to be heading over the next three, five, six weeks.

You can do that if you follow breadth. Breadth is technical in nature, so you can still throw that into the technicals, but a lot of people don't follow it. We follow eight, maybe 10 different breadth indicators. Volume analysis also needs to be followed. It is important to backtest a strategy. You have to use it and practice with it. It takes a good year or longer to get comfortable with it and start feeling like you can rely on it.

Every time I get hit with a loss, I do a robust postmortem by looking back and identifying indicators I missed, why I missed them, and what I could have been watching to give me more visibility into this huge correction that happened out of nowhere.

You want to be watching breadth closely but in addition to the US charts, you also want to watch fundamentals such as the European charts, Asian charts, and what is going on around the world. You also want to look at the macros such as earnings. This gives you insight into how careful you need to be when you are opening trades.

The addition of fundamental data came after the crash in 2008, because that was just devastating for so many traders. So many of us got hit hard. I had all kinds of trades open. At that time I was purely technical in nature. I would almost avoid the talking heads on TV and avoid any fundamental data. I knew that the charts through most of 2008 were bearish, where the 50-day moving average (MA) was under the 200-day, and the 100-day MA was under the 200, and you could see it on a daily basis. But you didn't know how bad it was going to be, and if you were watching the deterioration in earnings and the macros, you would have been even more careful.

This is why our advisory is so robust. Each one that gets sent out has 65 to 70 charts. Some people look at that and get analysis paralysis. It is the case for some people, but not for us. I know every single chart in my mind and what it is telling me. So it is not analysis paralysis, but I don't want to add anything else if I don't have to.

We watch everything. It gives us indications and probabilities of which way this market is going to go over the next four to five weeks.

When it comes to credit spreads and iron condors, we only need to be right four weeks at a time. The market can be trending up, it can be trending down, it can be going sideways and choppy as long as we remain in a plus or minus 10% band over a three- to five-week period; we will keep the premium. So that is where all this fundamental data comes in handy, in addition to technical data, volume data, and of course watching the calendar so we know when the next FOMC meeting is, and when [Fed chair] Ben Bernanke is going to be speaking.

We also want to know when [Secretary of the Treasury] Tim Geithner is going to be speaking to Congress. We want to know when China will be lowering rates. We want to be watching all this information because it moves the market and it moves volatility.

It also helps us to open our trades, because we want to time those top bear call spreads when the market has some nice strong up days. And we want to open up the bottom bull put spreads when the market has strong down days. And all this data gives us the best probabilities of being right and predicting what the market is going to do over four, five, and six weeks.

You call your business Monthly Cash Thru Options. Is that because you use income-generating strategies such as credit spreads and iron condors?

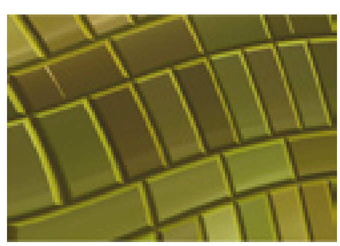
Exactly. From the get-go in 2003 I knew I was going to launch a competitive newsletter. So I had to focus on something and that was going to be income generation — sideways, nondirectional, income-generating strategies purely using credit spreads and iron condors on the indexes, not on the stocks.

I spent a year following a newsletter doing credit spreads on stocks, and after about nine or 10 months it became obvious to me that opening credit spreads on stocks was foolish. Just about every other day, one of our option spreads was on the dreaded watchlist. That was because stocks can move quickly. You have company-specific risks and industry-specific risks that you have to be careful with. After that, I decided to use only indexes.

And you limit yourself to only a few specific indexes as well. Why those?

We wanted indexes whose options are traded electronically on at least four or five exchanges, so there is competition. It is nice to have options on indexes that have a lot of open interest. But the market maker can make a market even if there is not a lot of open interest, because they can hedge on the other side of that trade if it is an index. There might only be open interest of 50 contracts and then when MCTO comes in, we might open up 10,000 to 15,000 contracts and the market maker still can make the market. Then we can get out of that trade if we need to, because there is competition.

We are looking for broad-based indexes. We want one that tracks small caps, so that is the Russell 2000 (RUT). We want one that tracks large caps, so that's the SPY or the SPX but we usually do the SPY, which is the exchange traded fund (ETF) that tracks the Standard & Poor's 500, and then we do the



MNX, which is the mini NDX. We are looking for indexes that have liquidity and represent the small caps, large caps, and the technology sector, because they all move differently. That gives us some diversification.

When the market is trending up, they are not all necessarily trending up with a correlation of 1.0. We might get hit on one set of trades if the market is trending up and if it is a bad month and some of our trades just didn't pan out, we get hit, but maybe the other ones don't. So there is some diversification. We want to trade European-style options, not American. That gives us some flexibility just in case something gets hit. We can roll it and not worry about it getting assigned.

Why do you prefer to trade the SPY over the SPX?

The SPX is a proprietary product traded only on the CBOE. There is no competition at the exchange level. We roll our trades so if a trade gets hit, we do not walk away from the trade. Credit spreads are highly leveraged. You can lose quickly with credit spreads. The losses can build up fast. When a trade gets hit, and that is usually about once a year because we weren't correct in our analysis and the market moved too much too fast, we will open up some trades. We don't walk away from the trades.

What we do is roll them and adjust them. If you have options on the SPX, it is hard to get out of those because there is no competition. The floor traders — I think they still use the shout-out method with options on the SPX — will just eat you alive. You have to be careful using the SPX. We use it once in a while, but we are aware of the dangers of using the SPX.

We like trading the SPY. We do two point–wide spreads. The commissions are high on the SPY, but it is just as effective. There is tons of liquidity. We can get in and out of those trades quickly, and there is lots of competition at the exchange level because it is traded electronically on many exchanges.

You only do two-point spreads on the SPY?

Two point–wide spreads on the SPY, five point–wide spreads on the MNX, and 10 point–wide spreads on the RUT.

You stick with credit spreads and iron condors. Are there other strategies you look at?

For this particular newsletter, it is just iron condors and credit spreads. We leg in. We don't just open up all four legs of an iron condor — that is, top credit spread and bottom credit spread, at one time. We time the market. When the market is trending up, we see that breadth is starting to increase or improve, we see the candlesticks starting to show certain behaviors, we see volume oscillators starting to give bullish signals, and things start moving above certain moving averages. Then we will quickly open up our bottom spreads, because we know that the market is going to start leaving those spreads behind. So we open up those bottom spreads and collect premium.

The market starts climbing and then we time when we open the top, because we want to bring in as much premium as possible, but we don't want to get hit either. It is a delicate balance when to open them and how much time to let go by before you open them up. So it's just credit spreads and iron condors, and that is all we do for this newsletter.

Not too long ago, the markets were volatile and they still can be. They go up so much on one day and down so much another day. How do you protect yourself from these wild moves?

As long as volatility doesn't move too much when we open up our credit spreads, the volatility allows us to open up spreads that are wider. We do wide-mouth iron condors so we can open up very far out-of-the-money bear call spreads that are several strikes above past resistance levels and we can open up bull-put spreads that are many strikes below past support levels.

If the volatility starts increasing and stairstepping higher, that is a sign a hurricane is coming in. You need to be wary, especially with credit spreads when you see volatility moving.

Let's say the VIX is at 30. That is pretty high. We can still open trades and make

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good money with the VIX at 30. It just needs to stay at 30 or start dropping a bit once we open our trades. If that pops up to 40 or 35, we need to be careful.

We might start opening some directional hedges. We might just close out of some trades and take a small loss and step aside. There is nothing wrong with that. This is a marathon, not a sprint. We just want to make sure we can stay in the game. So we will step aside if volatility starts popping up while we are in trades.

But behavior has not changed too much. If the VIX is at 30, the market behaves a certain way. If the VIX is at 50, it is going to behave a certain way. If the VIX is at 15 or 16, like it is today as we're talking, it is going to react a certain way. It is similar to volatility, but it is just that when volatility is higher, the market can bounce and whipsaw directional guys and take us out too. We have to pay attention to time the market.

One other thing we do is layer our strike prices. We take our time and collect spreads over a two- to three-week period. It's a month-long cycle, but we will collect our spreads all the way up to the last minute. Over a two- to three-week period, we collect our spreads — we call it just bringing in premium — and collect premium using maybe 10% of our cash on the days that our recommended spreads are filling. Then we layer our strike prices trying to give us some diversification. So we have layered strike prices, three different indexes, and we collect them over time. That is how we manage risk.

Risk management in options is different from risk management in equities. With equities you have your stops and position sizes. In options you have more variables to look at. Do you look at all of that?

We monitor delta and we try to stay

delta-neutral, or try to keep delta low. If delta starts climbing too high on a particular short leg, we will buy a call, or buy a put here and there to keep delta as low as possible. We do manage via the greeks in addition to managing via timing the market and layering strikes and collecting premium over time. Really, we are a hybrid.

You will see people go all greek-based. They don't have any prediction where an index is going to go. When expiration is done for that Friday of that week for that month, they jump in the following Monday and they look at where the RUT or SPX is. Then they open positions that they manage via the greeks. That is one approach.

The other approach is to time the market technically, and not watch the greeks too much. We do all three. We look at fundamentals to give us a broader macro prediction of which way the market is trending, we look at the technicals, and we look at the greeks. All three have to be done to give you the highest probability of not taking huge losses.

You can get hit with big losses if you are not careful with credit spreads. That can happen every nine to 15 months. You can have a nasty loss and give everything back. Since we watch the fundamentals, technicals, and greeks, plus adjust rolling trades, when we have losses, we can usually keep them under 7%.

Isn't there a huge risk when you are selling options if it goes against you?

It is a sliding scale. There is no free lunch. It is all built into the math based on probabilities and risk. I risk one dollar to make three. I risk a buck, but I can triple my money. I have a 10% or 15% probability of being right.

The other extreme of the spectrum is credit spreads. I can risk $9 to make $1. I have the potential to make 10% on my money, and there's a 90% probability I'll be right. The math is all the same as you move across that spectrum. Or I can risk a dollar to make a dollar and there is a 50% chance of being right and a 50% chance of being wrong.

It is also good to diversify, to do some of each. The directionals tend to be when you risk a buck to make three. But it is a directional trade and you are risking a small amount of your capital per trade, and it is higher frequency in nature.

For credit spreads, or any other extremes where we are risking $9 to make $1, you are trying to make 10% or 8%, or 6% or 7% for the month, but there is a 90% probability of being right. If you don't adjust your trade and don't know how to roll trades, you will most likely give all those gains back. You will make money for 10 or 11 straight months, and then on month 12 you will give it all back, plus even some of your principal. That is where the experience of being able to adjust and roll trades plays a big role.

I have about a nine-year track record now and I get hit about once a year. If it is a really bad year, a few of our trades will get hit twice a year. But we can usually roll them or adjust them, and that will extend the trade for an extra 30 days. Instead of a 30-day trade it is now a 60-day trade and we can usually keep the loss under 5%. Sometimes we can just break even on the trade. But it's okay. Of course, I'd prefer to make a bit — but if I don't, I don't.

I am going to give something back to the market once or twice a year. If I can keep that loss under 5% or 7% I am happy and our customers are happy. We know it is going to happen. It is part of the business. If you don't roll your options you are going to end up taking an 80%, 70%, or 60% loss. Even if you got out of the trade as fast as you could, you are probably going to take a 40% loss. You are still going to give back a pretty big chunk of six months' worth of gains. You have to know how to adjust and roll the trades.

Given that you use income-generating strategies, which are not strategies a daytrader would use on average, how many trades do you place per day?

For autotrading, which is the trading we do for our customers, we will place 10 credit spreads per month, creating five iron condors. We will collect those 10 credit spreads over a two- to three-week period. They all expire within 30 days or less.

Are autotrades strictly for the customer?

It is. We do the trading for them. We send the trades into the brokers. We communicate to the brokers on a daily basis. When we make a trade, we are in communication with the brokers on a minute-by-minute basis for about a 10-minute period as we get the fill.

Is your fund something the average person can buy on the exchange?

Not now. What we have for the retail trader is the newsletter, which has an autotrade feature. It comes out once a

"The bad news is that there is no real news. One side stalls, the other may or may not cave in – so much for clear direction. Talk about a cliff edge..."

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week and then a couple of other advisories during the week if necessary, plus we autotrade for customers if they want it. It is the same thing with the other funds we are developing. They are going to be retail-based newsletters with an autotrade feature. What is different about the ones we are developing now is that they are going to be targeted to institutions. But we will be starting it off as a retail-based newsletter.

Could you explain to our readers what a credit spread is?

An iron condor is two credit spreads. You have a bear-call spread and a bull-put spread. When you place those two together you create an iron condor.

A bear-call spread is when we are selling options to the speculators. Let's take the RUT as an example. Say the underlying is at 800 and we decide to sell the RUT 840/850 bear-call spread. What we are doing is selling the 840 call and we are buying the 850 call for protection. By selling the 840 call, we are on one side of the trade and a speculator is on the other side of the trade. They think that the RUT is going to go up. They want to buy that 840 call. They have to buy it from someone. That comes from us. We sell it. The 840 call is worth more than the 850 call, so we bring in a credit. So we are bringing in premium when we sell the 840 call and buy the 850 call for protection. That is called an 840/850 bear-call spread.

Let's assume the market is choppy and moving sideways. If you line up 100 traders, you'll find that approximately 50 will be bullish and 50 will be bearish. Let's say the Dow Jones Industrial Average (DJIA) is up for three consecutive days, 80+ points every single day. The bulls get excited. They might say, "I want to buy calls on the RUT! I want to buy that 840 call and I am willing to spend more money on it, because today was an up day." That is when we open our storefront and we sell the 840 calls to the speculators. Then we buy that 850 call to protect ourselves.

Say a couple of days later the market is going down for two or three or four days. The bears get excited and they want to buy puts. Say they want to buy, for example, the 750 put. So we will sell that 750 put, but it is only good for three weeks, which is a very short period of time. It is only good for two weeks, three weeks, four weeks, maximum. So we sell the bearish person the 750 put and we buy the 740 put for protection. That is called the 750/740 bull-put spread.

So we alternate. On the strong up days we sell the calls to the bullish folks, and on the down days we sell the puts to the bearish folks. We are like the house of the casino. We are satisfying both the bullish speculators and the bearish speculators. We do a lot of analysis. We tend to be ahead of the crowd, so there is a higher probability that we are going to be right. We usually keep the premium. That's the game. You've got that 840/850 bear-call spread and then you have that 740/750 bull-put spread. When you connect them, you have an iron condor.

It sounds simple, but you probably need to know it well to succeed.

Credit spreads are deceivingly simple, but they are hard to make consistent money without giving a lot back. You have to be careful with them. Realistically, they are very difficult to make consistent money and keep your losses under 7% when you have them. That is key, and that is what is really hard to do.

Thank you very much for speaking with us, Brad.